



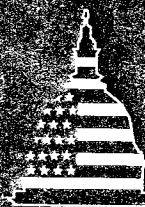
United States General Accounting Office

Report to the Ranking Minority Member  
Committee on Commerce  
House of Representatives

April 1999

# SECURITIES REGULATION

## Actions Taken to Improve Nasdaq Listing Procedures



GAO

Accountability \* Integrity \* Reliability

General Government Division

B-281373

April 26, 1999

The Honorable John D. Dingell  
Ranking Minority Member  
Committee on Commerce  
House of Representatives

Dear Mr. Dingell:

This report responds to your request that we determine whether the Securities and Exchange Commission (SEC) and Nasdaq Stock Market, Inc. (Nasdaq) have implemented the recommendations in our report, Securities Regulation: Oversight of SRO's Listing Procedures Could Be Improved (GAO/GGD-98-45, Feb. 6, 1998). We made our recommendations to improve the oversight and operations of Nasdaq's Listing Qualifications Department (NLQ). As also requested, we include information on the status of Nasdaq's response to recommendations SEC made as part of its oversight of NLQ and information on the status of Nasdaq's new automated Risk Scoring Compliance System (RSCS).

## Results in Brief

SEC and Nasdaq have implemented our report's two recommendations. First, SEC's Office of Compliance Inspections and Examinations (OCIE) developed and issued its first report to SEC Commissioners on significant, open recommendations resulting from OCIE inspections. OCIE's report included not only recommendations involving listings programs, but also those from OCIE inspections of various other self-regulatory organization (SRO) regulatory programs.<sup>1</sup> Bringing open, significant inspection recommendations to the attention of SEC Commissioners, and letting the SROs know that this is being done, provides additional incentive for SROs to comply with OCIE recommendations. Second, NLQ has started preparing quarterly reports to Nasdaq's management that provide statistical measures of the listing program's results. The report contains information pertaining to three primary NLQ activities, including (1) exception granting and administration, (2) application review, and (3) compliance monitoring. Routinely reporting these overall program statistics to Nasdaq management should help to keep officials informed

<sup>1</sup>National securities exchanges and registered securities associations, along with registered clearing agencies and the Municipal Securities Rulemaking Board, are collectively termed SROs under Section 3(a)(26) of the Securities Exchange Act of 1934.

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about whether the listings program is achieving results appropriate to program goals.

Nasdaq and SEC officials said that Nasdaq has addressed all 27 of the recommendations resulting from OCIE's 1997 inspection of NLQ. SEC officials told us that they would follow up on three of these recommendations during the next OCIE inspection of Nasdaq to ensure that the actions taken have been effective. For example, SEC recommended that to remain listed on Nasdaq, companies receiving "going concern" audit opinions must submit business plans that demonstrate their ability to continue in business.<sup>2</sup> Nasdaq reported that it would require such companies to submit business plans. Nasdaq officials said they used these business plans to focus the companies' attention on issues raised by the going concern opinions and compliance with listing requirements. However, Nasdaq officials reported that OCIE recognizes that Nasdaq would refrain from making subjective determinations regarding the potential success of the business plans while the companies are still in compliance with listing requirements.

Nasdaq officials told us that they have made substantial progress in their development of RSCS. They said that they expect RSCS to be implemented into Nasdaq's compliance monitoring program some time during mid-1999. They said that RSCS is to help NLQ analysts more quickly detect problem companies that are falling out of compliance with Nasdaq listing requirements.

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## Background

Nasdaq is the subsidiary of the National Association of Securities Dealers (NASD) that is responsible for developing, operating, and maintaining systems, services, and products for the Nasdaq over-the-counter securities market. It is also responsible for formulating regulatory policies and listing requirements applicable to this market. The Nasdaq unit responsible for administering its program to list companies on the Nasdaq market is NLQ.

NASD is the largest SRO in the United States, with a membership that includes virtually every broker-dealer in the nation that does securities business with the public. NASD is subject to SEC oversight and is responsible for ensuring that its members comply with federal securities laws and NASD rules. NASD, through its regulatory subsidiary NASD Regulation, Inc., is responsible for regulating Nasdaq's over-the-counter securities market. NASD develops rules and regulations, conducts

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<sup>2</sup>A going concern opinion may be issued as a result of an external auditor's review of a company's financial status that raises questions about the company's ability to remain in business.

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regulatory reviews of members' business activities, and designs and operates marketplace services and facilities.

Nasdaq began operation in 1971 as the first electronic, screen-based stock market for over-the-counter securities. Nasdaq enables securities firms to execute transactions for investors and for themselves in an environment of real-time trade reporting and automated market surveillance. As of December 1998, more than 5,580 securities were traded on Nasdaq, representing about 5,100 companies. In addition to its screen-based operations, Nasdaq is distinguished from stock exchanges by its use of multiple market makers—-independent dealers who openly compete with one another for investors' orders in each Nasdaq security. Nasdaq has two tiers: the Nasdaq National Market, where about 3,900 of Nasdaq's larger companies are listed and traded; and the Small Cap Market, where about 1,200 smaller emerging growth companies are traded.

Our February 1998 report made two recommendations for improving the oversight and operations of NLQ. First, we recommended that OCIE periodically report the status of all open, significant recommendations in its oversight inspections to the SEC Commissioners. Second, we recommended that SEC require NASD to develop management reports based on overall program statistics to demonstrate NLQ's operating results.

In August 1997, OCIE completed a periodic compliance inspection of NLQ. The SEC staff made 27 recommendations for improving NLQ's review of listing applicants and the compliance status of listed companies. The inspection report placed special emphasis on five of these recommendations.

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## Objectives, Scope, and Methodology

Our objectives were to determine whether SEC and Nasdaq have implemented our recommendations and to determine the actions Nasdaq has taken to respond to SEC's inspection recommendations. We also determined the operational status of RSCS. We interviewed SEC and Nasdaq officials and reviewed applicable documents regarding these matters.

To determine whether our recommendations have been implemented, we met with appropriate SEC and Nasdaq officials; examined OCIE's August 20, 1998, information memorandum to SEC Commissioners; and examined reports of Nasdaq Listing Qualifications Program Statistics for the quarters ended June 30 and September 30, 1998. To determine the status of Nasdaq's compliance with OCIE's inspection recommendations, we met

with appropriate SEC and Nasdaq officials, reviewed documents relating to SEC's follow-up to the 1997 inspection, and reviewed NLQ procedures. To assess the operational status of RSCS, we obtained a briefing on and demonstration of RSCS from Nasdaq officials.

We obtained written comments on a draft of this report from SEC and Nasdaq (see apps. I and II, respectively); and their comments are discussed at the end of this letter. We did our work in Washington, D.C., between October 1998 and March 1999 in accordance with generally accepted government auditing standards.

## SEC and Nasdaq Developed Reports in Response to Our Recommendations

In August 1998, in response to our recommendation, OCIE submitted an information memorandum to the SEC Commissioners that included the status of significant open recommendations resulting from OCIE inspections of the securities SROs. The memorandum provided background and operational information on OCIE's SRO inspection program and a discussion of the status of open recommendations that OCIE considered significant. The purpose of our recommendation was to keep the commissioners informed and to provide an additional incentive for SROs to comply with OCIE recommendations. OCIE's memorandum addressed recommendations from all OCIE SRO inspection programs. These included inspections of SRO listing programs, as well as other SRO activities, such as

- arbitration;
- broker-dealer examination;
- financial surveillance and enforcement; and
- trading surveillance, investigation, and enforcement.

OCIE indicated that it would annually report the status of all open, significant recommendations to the Commissioners.

In August and November 1998, NLQ sent Nasdaq management quarterly statistical summary reports on the progress of the Nasdaq listing program. These summaries used statistical information as indicators of the effectiveness of Nasdaq's listing program. The reports provided information pertaining to three primary activities within NLQ—exception granting and administration, application review, and compliance monitoring. For example, the reports for the quarters ended June 30, 1998, and September 30, 1998, indicated that the number of issuers granted exceptions as a percent of those requesting exceptions to Nasdaq's listing requirements generally had diminished. They also indicated that the

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percentage of issuers removed from the listings for failing to comply with the terms of their exceptions increased.

The quarterly report is expected to support NLQ's primary objective of promoting the integrity of the Nasdaq Stock Market through the consistent application of Nasdaq's listing requirements. The report was developed in response to our recommendation that NASD use statistics to demonstrate NLQ's operating results and evaluate program effectiveness.

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## Nasdaq Has Acted to Comply with SEC's Recommendations

In August 1997, OCIE reported on its inspection of NLQ and made recommendations for improving Nasdaq's review of applicants for listing and companies already listed. In total, OCIE made 27 recommendations to improve the operations of the Nasdaq listing program. OCIE officials told us that Nasdaq had addressed all of the 27 recommendations. They reported that they intend to follow up on three of the recommendations to ensure that the actions taken have been effective.

OCIE's inspection report highlighted its recommendations in five key areas. OCIE recommended that NLQ:

- implement procedures requiring its analysts to closely scrutinize the value of unaudited assets and the value of audited assets that are unusual or of questionable value;
- train its analysts to thoroughly investigate and evaluate disclosures made by issuers in public filings and press releases and require its analysts to routinely conduct investigations into the backgrounds of those individuals involved with issuers, including independent accountants and underwriters;
- implement procedures to require companies that receive going concern opinions to set forth a business plan demonstrating their ability to continue business operations in compliance with listing requirements;
- create a uniform, concise compilation of its basic review procedures; and
- modify its program to monitor listed companies to enable NLQ to more quickly detect companies that are falling out of compliance.

In responding to each of these recommendations, Nasdaq has made various procedural and program changes. Nasdaq officials reported that Nasdaq has revised its procedures manuals to include detailed written procedures for valuing assets. For example, they said the procedures now document Nasdaq's practice to consider requesting corroboration of the value of assets if the issuer's financial statements contain nonperforming assets, assets related to discontinued operations, significant percentages of intangible assets, undeveloped natural resources, or assets acquired

related to nonmonetary transactions. However, unless unusual circumstances exist, Nasdaq staff are to continue to rely upon asset valuations that have been validated by a company's independent auditor. To improve its ability to investigate issuers and company information, Nasdaq created the Nasdaq Listing Investigations Department (NLI) in July 1997. NLI is responsible for doing in-depth investigations into Nasdaq-listed issuers. Nasdaq officials told us that NLI has experienced legal and accounting staff dedicated to this effort. Nasdaq reported that as of mid-February 1999, NLI had initiated about 85 investigations. About 20 of these have involved, at least in part, questions concerning asset valuation. Nasdaq reported that, in several instances, these investigations caused companies to restate their financial statements. Other investigations have focused primarily on the adequacy and accuracy of issuers' press releases.<sup>3</sup> Nasdaq officials said that although a number of these investigations are ongoing, the ultimate disposition has ranged from requiring or encouraging clarifying or corrective public disclosures to removing companies from the listings, at least in part, because of their misleading press releases.

To address issues related to companies receiving going concern opinions, Nasdaq officials reported that they would require these companies to submit business plans. Specifically, Nasdaq would require companies receiving going concern opinions from their auditors to provide business plans that show how the company intends to continue business operations in compliance with listing requirements. SEC stated that this should allow better communication between Nasdaq and issuers about the chances of continued listing, given operating problems that caused the companies to receive going concern opinions. Nasdaq officials said they used these business plans to focus the companies' attention on issues raised by the going concern opinions and compliance with listing requirements. Nasdaq officials also reported that OCIE recognizes that Nasdaq would refrain from making subjective determinations regarding the potential success of the business plans while the companies are still in compliance with listing requirements. They also reported that they have heightened their scrutiny of companies that receive going concern opinions. For example, they said they can identify companies that have going concern opinions in an automated information system, called the Issuer Support Services system. They said they note which companies have going concern opinions on Nasdaq's filing review form, which Nasdaq uses for reviewing periodic filings, and they assign higher risk factors to these companies in Nasdaq's

<sup>3</sup> Nasdaq's Market Watch Department has primary responsibility for timely review of companies' press releases and, when appropriate, may implement temporary trading halts in a company's stock for the dissemination of material news.

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new RSCS. Further, they said all Nasdaq hearing memoranda involving noncompliant companies reflect the presence of going concern opinions.

To make Nasdaq procedures manuals more uniform and concise, Nasdaq officials have revised the manuals and included indexes and tables of contents. These officials said Nasdaq reviews its compliance program quarterly and updates the manuals as needed. NLQ has provided OCIE and us with copies of the revised manuals.

To more quickly detect companies that may be subject to compliance problems, Nasdaq began developing its automated RSCS in January 1997. Nasdaq officials reported that RSCS is to monitor, among other things, significant changes in the value or composition of a company's assets. Also, in June 1997, Nasdaq established an electronic interface with SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system, which provides real-time access to issuer filings. Nasdaq officials said that this will enable Nasdaq to evaluate issuer filing delinquencies on a substantially accelerated basis. They said financial data obtained through EDGAR is used to update Nasdaq's database, allowing Nasdaq to focus more quickly on an issuer's compliance with listing requirements.

OCIE officials told us that they intend to follow up during OCIE's next NLQ inspection to ensure that Nasdaq corroborates asset valuations, evaluate Nasdaq's approach to going concern opinions, and assess Nasdaq's handling of companies with filing delinquencies. With respect to delinquent filings, OCIE recommended that Nasdaq remove companies from its listings after a specified number of delinquencies. Nasdaq reported that it believes the issue of companies with chronic delinquent filings should be aggressively addressed. However, Nasdaq officials told us that they were concerned that changing listing requirements to remove companies after a specified number of delinquent filings would imply a "safe harbor" for companies that have received fewer than the specified number. They said the filing requirement could be better enforced on a case-by-case basis. OCIE officials told us that the next inspection of Nasdaq's listings department is scheduled for August 1999.

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## RSCS Is Scheduled for Implementation During Mid-1999

Nasdaq officials told us that they have made substantial progress in their development of RSCS. They said that they expect RSCS to be implemented into Nasdaq's compliance monitoring program some time during mid-1999. They said they had experienced some technical difficulties with RSCS, but they have continued to fine-tune the system and increase its technological capabilities. They said the purpose of RSCS is to help NLQ analysts more

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quickly detect companies with potential compliance problems that might require additional scrutiny.

Nasdaq designed RSCS to assign risk scores to companies by evaluating various factors called "alert items." Alert items are indicators that Nasdaq has identified as predictors of potential problems at a company or with some aspect of a company's securities on the Nasdaq market. Specific alert items include data on changes in trading volume, share price, or total shares outstanding; listing requirement statistics, such as net tangible assets, market capitalization, or market value of public float; and the auditor's opinion of the company's financial statements. Each alert item is associated with a threshold value. Data for a company are evaluated against each of these thresholds; and if the threshold is exceeded, the alert item for that company is assigned a score. Scores for each alert item associated with a company are totaled. The companies with the highest scores are those that may require more diligent monitoring by NLQ analysts.

Nasdaq officials said that they are obtaining most of the data required for RSCS from databases available within NASD. They said the exact items included in the final RSCS depend, in part, on the availability of external data.

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## Conclusions

SEC and Nasdaq promptly responded to both of our February 1998 recommendations. In addition, OCIE and Nasdaq have worked closely to implement and resolve any differences concerning OCIE's inspection recommendations. As a result, OCIE has stated that it is satisfied that Nasdaq has addressed all of its recommendations. OCIE's plans to follow up on three recommendations should help ensure that Nasdaq has appropriately responded to those recommendations.

It is too early to tell whether RSCS can provide effective early warning of companies that may be falling out of compliance with Nasdaq listing requirements. If effective, RSCS could help analysts identify troubled companies that need additional scrutiny.

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## Agency Comments and Our Evaluation

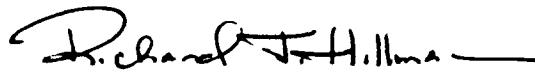
SEC and Nasdaq generally agreed with and had no substantive comments on this report. They orally provided technical comments, which we incorporated where appropriate. Their written comments are shown in appendixes I and II, respectively.

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As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 10 days from its issue date. At that time, we will send copies to Representative Tom Bliley, Chairman, Committee on Commerce; the Honorable Arthur Levitt, Chairman, SEC; Mr. Frank Zarb, Chairman, NASD; and other interested parties. We will also make copies available to others upon request.

Major contributors to this report are listed in appendix III. Please contact me at (202) 512-8678 if you or your staff have any questions.

Sincerely yours,

A handwritten signature in black ink, reading "Richard J. Hillman", followed by a horizontal line.

Richard J. Hillman  
Associate Director, Financial Institutions  
and Markets Issues

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## Abbreviations

EDGAR	Electronic Data Gathering and Retrieval
NASD	National Association of Securities Dealers
NLI	Nasdaq Listing Investigations Department
NLQ	Nasdaq Listing Qualifications Department
OCIE	Office of Compliance Inspections and Examinations
RSCS	Risk Scoring Compliance System
SEC	Securities and Exchange Commission
SRO	self-regulatory organization



# Comments From the Securities and Exchange Commission



OFFICE OF COMPLIANCE  
INSPECTIONS AND  
EXAMINATIONS

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

April 1, 1999

Richard J. Hillman  
Associate Director  
Financial Institutions and Market Issues  
U.S. General Accounting Office  
Washington, D.C. 20548

Re: GAO Report: "Securities Regulation: Actions Taken To Improve Nasdaq Listing Procedures"

Dear Mr. Hillman:

Thank you for the opportunity to comment on the General Accounting Office's ("GAO") draft report entitled Securities Regulation: Actions Taken To Improve Nasdaq Listing Procedures. The GAO sought to determine whether the Commission and the Nasdaq Stock Market, Inc. ("Nasdaq") have implemented the recommendations in the GAO's previous report entitled Securities Regulation: Oversight of the SROs' Listing Procedures Could Be Improved (Feb. 6, 1998). The GAO recommended in its February 1998 report that the Office of Compliance Inspections and Examinations ("OCIE") report periodically to the Commission on significant, open recommendations resulting from OCIE inspections, and that the Commission require the NASD to develop management reports based on overall program statistics to demonstrate Nasdaq's Listings Qualifications Department's operating results.

The current report concludes that the Commission and Nasdaq have implemented both of the GAO's recommendations from its February 1998 report. In particular, as the report notes, OCIE has adopted procedures to apprise the Commission of significant, open recommendations resulting from OCIE inspections of self-regulatory organizations. Additionally, the report notes that Nasdaq's Listings Qualifications Department has provided quarterly reports to Nasdaq management on the progress of Nasdaq's listing program. The report also concludes that OCIE and Nasdaq have worked closely to implement and resolve any differences concerning inspection recommendations from OCIE's 1997 inspection report. The Commission recognizes that in implementing recommendations from OCIE's 1997 inspection report, Nasdaq has made significant

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**Appendix I**  
**Comments From the Securities and Exchange Commission**

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Richard J. Hillman  
Page 2

changes in procedures and technology that will require continued monitoring through the inspection process.

Thank you and your staff for your courtesy during this review.

Very truly yours,

A handwritten signature in dark ink, appearing to read "Lori Richards", written in a cursive style.

Lori A. Richards  
Director

# Comments From the Nasdaq Stock Market, Inc.



March 31, 1999

Mr. Richard J. Hillman  
Associate Director, Financial Institutions  
and Market Issues  
General Accounting Division  
U.S. General Accounting Office  
441 G Street, NW  
Washington, DC 20548

Dear Mr. Hillman:

Thank you for providing us with a copy of the draft Report entitled Securities Regulation: Actions Taken to Improve Nasdaq Listing Procedures. We have also reviewed several pages of further revisions which were provided to us by your staff. Based upon our review of that material, we have no further comments.

Sincerely,

A handwritten signature in dark ink, appearing to read "Michael S. Emen", followed by a small flourish or mark.

Michael S. Emen  
Vice-President  
Nasdaq Listing Qualifications

cc: David P. Tarosky  
Frank Zarb  
John H. Komoroske

The Nasdaq-Amex Market Group, An NASD Company  
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# Major Contributors to This Report

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General Government  
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David P. Tarosky, Senior Evaluator



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